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Strategic Audit of the Public Accounting Industry with a Focus on EY

Mary Candela
University of Nebraska-Lincoln

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by
Mary Candela, BA
Accounting
College of Business

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Faculty Mentors:
Dr. Sam Nelson, PhD, College of Entrepreneurship

Abstract

Public accounting firms provide valuable assurance services that, because of their place in our economic system and because of strong regulatory requirements, are unlikely to stop being demanded. The industry is facing several issues surrounding stagnation of the client base and difficulty in competition. Finally, the industry is also being rocked by the pace of emerging technologies and will need to adapt to and embrace them in the coming years.

The following uses several strategic frameworks to analyze the industry, the subset of the Big Four accounting firms, and EY. Ultimately, this project develops and understanding of EY's place in the market and presents several alternative suggestions for corporate strategy going forward.

Key Words: Public accounting, strategy, EY, technology

Background and Issues

Public Accounting

The public accounting industry provides assurance and consulting services to public and private businesses. These are generally split into audit, tax, and consulting business units. This exploration will focus on audit/assurance services, but will keep the context of these other services in mind.

History

Accounting/record keeping has existed for hundreds of years. Our system of double entry accounting dates back to 1494 Venice. Public accounting services have been around since at least the mid-18th century and probably before. Public accounting is a kind of mysterious service from the outside as it's one of many industries that finds itself in the gap between two more solid ideas. Because of our system of Agency between companies' **managers** (agents) and **owners** (principles), there exists an **information asymmetry**. Assurance services seek to bridge that gap by *assuring* owners that the managers of their businesses are reporting on their performance accurately.

Why is this Important?

Assurance services form the backbone of our economic system. Investors can buy stock knowing that the price they are paying is based on materially correct financial statements. Companies can hire other companies knowing that the services they provide are safe. Companies can merge with other companies knowing that the assets they acquire are correctly valued. Employees can put money into retirement and stock plans knowing that their employers are accountable to them.

Regulation

Because of how important it is to our economic structure, public accounting is a highly regulated industry. These regulatory bodies range in origin and power but are a huge part of the ways public accounting provides services to businesses. The following are just a handful of these bodies.

- **American Institute of CPAs (AICPA)** - A professional organization that has been operating since 1887 that maintains the integrity of the public accounting profession by creating a code of ethics, a series of certifications (including Certified Public Accountants), and standards for audits of privately held companies.
- **Securities and Exchange Commission (SEC)** - Created in 1934 as a reaction to stock market crashes, the SEC aims to protect investors and improve public confidence in exchanges. The SEC oversees the PCAOB and investigates companies and individuals for improper accounting practices and fraudulent activities that harm investors. The SEC has a big reach and provides a lot of financial reporting regulation and guidance.

- **Sarbanes Oxley Act (SOX)** - Passed in 2002 as a reaction to large accounting scandals such as Enron, SOX lays out requirements for public companies. Notably, this act required audits, layed out public reporting requirements, and defined independence requirements for both public accounting firms and companies' Audit Committees.
- **Public Company Accounting Oversight Board (PCAOB)** - Created in 2002 by SOX, the PCAOB oversees audits of publicly traded companies. The PCAOB sets standards, investigates public audits, and imposes sanctions against firms that fail to uphold those standards.
- **Accounting Regulators** - These are also monitored by the SEC and include the Financial Accounting Standards Board (FASB), which forms Generally Accepted Accounting Principles (GAAP), and the International Financial Reporting Standards (IFRS).

This provides some context about the regulatory environment of public accounting, some familiarity with terms, and also emphasizes how locked down the industry is. Because of the sensitive nature of financial markets and the potential losses in those markets for millions of Americans, public accounting services require this kind of structure. Bridging the information asymmetry gap between owners and managers can only be done by a firm and a profession that can be trusted.

Public accounting firms are selling integrity. Any threat to that integrity will crumble a firm like sand because the service they sell is not longer worth a cent. This is why Arthur Andersen couldn't survive the Enron scandal.

The Big Four

Public accounting is lead by the "Big Four" accounting firms in terms of revenue by a wide margin. These firms are (in order of revenue) Deloitte, PricewaterhouseCoopers (PwC), EY, and KPMG. The fourth largest firm, KPMG, is 4.7 times as large as the fifth largest firm, RSM. These four firms serve most of the nation's largest companies while smaller firms serve more mid-sized, family owned companies or focus on specific industries or products.

There are some concerns that the Big Four (formerly the Big Eight and then the Big Six) are "too big to fail" and because of that may stop being as concerned about regulatory compliance as there is no threat of consequence. According to a study done by Harvard Business School, there actually may be the opposite result as these companies feel less pressure to compete. Regardless of the effect, it is true that this low number of large competitors has an impact on the industry.

EY

EY, formerly known as Ernst & Young, is the result of a merger in 1989 between two public accounting firms that dated back to the early 1900s. EY's mission is to "build a better working world" and does so through the products it offers businesses and through other ways it involves itself in the business community.

Summary of Issues

- Stagnation of client base due to the requirement that public companies be audited.
- Difficulty in differentiation and attracting clients because the product offerings are so uniform as a result of high regulation.
- Technology and data are advancing. While professional service firms and audits will never stop being valued, the way they are done is likely to change and the firms will need to work hard to stay on top of change and continue to deliver value to their clients.

Situation Analysis

This analysis will focus on EY's perspective, but much of this analysis applies to all of the Big Four firms as they are so similar in business model and services.

Business Model
EY provides the following services:

- **Assurance** (Audit) **-** Provides independent assurance to stakeholders that a company's financial statements are fairly presented in accordance with a financial reporting framework. There are also other types of audits that provide assurance about internal controls over financial reporting, IT controls, third party systems, and more.
- **Tax -** Provide experience in tax planning, compliance, and reporting. There are also tax consulting services that can be offered to non-audit clients that involve developing tax strategies and planning.
- **Advisory** - These are EY's consulting services focused on helping improve how clients run their business and processes. This includes a lot of important technological services.
- **Transactions** - This is an additional consulting line that focuses on strategies for managing capital and transactions. This is a focus area for EY.

The cost of hiring and training employees is EY's biggest cost. This means that a lot of effort goes into maximizing utility, assigning employees to different engagements based on time budgets, and charging time to specific clients.

Organization
EY, and most public accounting firms, are organized very interestingly. The vast majority of employees only stay in public accounting for 3 to 5 years before moving on to other opportunities in industry. This means that the majority of employees are new hires (often recent college grads) and need to learn quickly. There is an established promotion system and every level sees fewer employees. Public accounting work can be demanding so this turnover is unsurprising. Firms develop their employees a lot in 3-5 years so it isn't difficult for them to find other opportunities to apply their new skills and knowledge.

This means that the partner level is a fraction of the company and rather than focusing on the day-to-day tasks of the audit, they focus on overarching professional judgements as well as customer relationships, networking, and new client acquisition.

External Analysis

PEST Analysis

Political/Legal	Changes in regulation of public accounting firms have a big impact on their ability to do business. For example, other countries have requirements that public companies rotate auditors every few years. This additional restraint if implemented in the U.S. could put cost businesses a lot of money in switching costs. Regulation on financial reporting for companies also has a big impact on firms. Changes in tax law or Generally Accepted Accounting Principles can be very costly to implement. These can turn into consulting opportunities for firms.
Economic	This is not a bigger factor for public accounting firms than any other business as they offer a relatively necessary good. It does, however, affect the work they do. As pressure on businesses increases so does risk and so does the amount of work and skepticism that auditors need to employ. Firms will simultaneously be trying to cut costs while also increasing the amount of work they should do.
Social	The demand for public accounting is, at its core, driven by social factors. People demand security. This isn't going to change unless our economic system fundamentally changes. The demand for employees is high as regulation increases the amount of work required and the baby boomers retire and leave a gap in the job market. Additionally, the AICPA states that the 1990s saw a dip in accounting professionals as college grads took to IT positions.
Technological	This is the biggest factor affecting the world today and public accounting is no different. Firms' biggest interest today is in integrating technologies into the services they provide and making sure to stay ahead of new technologies so that they can best serve their clients and stay competitive in the professional services industry. See a more in-depth analysis of technological environments below.

Technology as an Opportunity

In general, EY will be looking to provide more consulting services to businesses that match the way they do business and the way they want to do business. This includes understanding their systems/data and helping them get more out of those tools.

In audit, public accounting is seeing *huge* changes. Companies have more and better data. Auditors have more and better tools. Data analytics and robotic process automation are going to change the auditing world. Automation of tasks and of analysis can make sure that the work that auditors do is less focused on routine manual tasks and more on professional judgements and insights. Auditors can automatically collect data and look at all of a company's transactions to identify risks. This means that audits are more efficient *and* more effective.

It is necessary to emphasize how much of a revelation this is to the audit world. Auditing has always been based in *sampling*. Because of human limits, audits are performed by randomly sampling transactions and testing them to make sure that they are correct. Big data and advances in machine learning and data analytics mean that audits could start testing *entire populations*. Auditors can spend their time looking at the really important or risky areas while a computer runs through the repetitive testing of transactions that don't really require judgement.

Technology as a Threat

Technology does not threaten the market for public accounting services, nor does it threaten the job market for these services. All technology does is change how the services are performed. New technologies are emerging and companies are racing to adopt them. Unfortunately, new technologies bring new risks. For public accounting this includes the following:

- Data security as auditors and tax professional make more and more digital requests is a high priority for clients.
- Cryptocurrencies require regulation not only for their use, but also for how they fit into accounting standards.
- Audits may shift from assuring users that the data (financial statements) is correct to instead to assuring users that the data analytics (algorithms that produce or audit financial statements) are correct.

Porter's Five Forces

Threat of new entrants	**LOW -** For the Big Four, this threat is low. The costs of entry include high regulatory requirements and the need to build up a client base. Smaller firms are unlikely to catch up with the Big Four as these global giants hold a huge amount of talent, resources, and large clients. That being said, this threat is a lot higher when you look at small firms. In order to start a small public accounting firm all you need are experienced CPAs, some starting capital, contacts in the community, and time to produce training and other regulatory materials.
Threat of substitutes	**LOW -** In general, the services that public accounting firms provide are regulatory or economic requirements. Companies will always require audit and tax services. Consulting services can be performed by individual consulting companies, but public accounting firms have a lot of talent and expertise in these areas. **HIGH -** When looking at EY specifically, the threat is a little higher. Because of regulation, all services are, at their core, the same. EY and

	other firms rely on high switching costs to maintain their client base. An audit is always the hardest to perform the first year.
Bargaining power of customers	**LOW** - The switching costs described above keep clients with their service provider most of the time. Additionally, public companies and some private companies require these services either by law or by their owners/customers/creditors.
Bargaining power of suppliers	**HIGH** - The "supplies" of the service industry are the employees and the tools they use. 1. Employees have bargaining power as public accounting is a relatively skilled industry and will only become more so as technology skills become necessary. Already employees need at least undergraduate degrees as well as CPA licenses. Additionally, CPAs have a lot of options for employment and *frequently* exercise that power. Public accounting has high turnover. 2. The tools that companies use tend to have high switching costs as the firms not only have to pay for the hardware/software, but also to train all (often reluctant) employees and potentially clients.
Competitive Rivalry	Ultimately, this analysis is an interesting one to do in this industry because competition is so localized by client base (size, industry, location). While the Big Four as a group see little rivalry from the rest of the industry, EY specifically sees competition from the other three firms. This is why a big part of the business model of these firms is in networking and "earning" the business of growing companies looking for a bigger auditor to match, or hoping to acquire the business of a dissatisfied client of another firm.

Internal Analysis

This analysis of competitive advantage focuses on EY competing with the other three big accounting firms. All of these firms share a huge number of **core competencies** that make them the Big Four public accounting firms. Additionally, this analysis will attempt to identify the **comparative advantages** (favorable access to resources) and **distinctive competencies** (relatively few things EY does better) that would contribute to EY's competitive advantage.

Core Competencies

The majority of what the firms call their strengths are actually core competencies or values. Delivering great service, helping clients achieve their goals and gain new insights, being a global company, working with new technologies, and providing employees with development opportunities are all expected parts of being one of these large firms. They are all prestigious and they are all working hard to achieve the same goals (global reach, technological advances, employee work-life balance).

EY lists the following as “The EY Difference”: Global mindset, top talent and employee development, and fostering of entrepreneurial businesses. How many of these are actually a competitive advantage and how many are just core competencies?

Comparative Advantages - Employees and Tools

EY is third in revenue, but second in employees. They employed 250,000 people globally in 2016/2017 compared to 263,900 at Deloitte. Though this is a resource they have, it isn’t necessarily better or worse than the employees of its competitors.

It’s unclear which of the firms is leading in technology. Deloitte, because it retained its consulting branch has a lot more focus on innovation than the other firms but that doesn’t mean it’s leaps and bounds ahead. EY has rolled out a client portal to get data directly from clients as well as research in robotic automation processing and other emerging technologies. These advances, however, are ones that may also be categorized as core competencies. Until a firm can patent their processes and until those processes start attracting clients to their firm in particular, technology will remain both one of the most important areas for public accounting growth and solidly in the core competency realm.

Distinctive Competencies

Of the items that EY lists and the structural and cultural differences it promotes, the following could potentially contribute to a competitive advantage.

- **Separate Financial Services branch** - EY separates its tax and audit groups first by financial services versus other industries and then by geographic region. Because of this, EY feels it can better serve the financial services industry by developing more experts with more experience.
- **Transaction Advisory services** - EY’s separate transaction advisory practice allows them to lead the industry in its expertise with this type of work.
- **Diversity** - EY’s focus on diversity is effective according to DiversityInc's Top 50 Companies to Work For where they were ranked #1 in 2017 and have placed in the top 10 since 2009. (Compared to 4, 11, and 12 from the other Big Four).
- **Entrepreneurship** - EY’s Entrepreneur of the Year program provides entrepreneurs and innovators with information, networking opportunities, and support. This is an excellent community and client development tool.
- **Branding: Building a Better Working World** - EY’s tagline is everywhere throughout their website and other materials. After rebranding in 2013, the firm is focused on delivering a consistent message to the world.

Conclusion

There is little to no differentiation between the Big Four accounting firms. They have different focuses, programs, and cultures, but in general offer the same products. Likely the biggest factor in a client’s decision to hire one firm over another is how good their relationships with their local offices are. How well does that particular office know their industry? EY may have the upper hand in some industries and some cultural focuses (diversity, entrepreneurship), but it may not be strong enough to call a competitive advantage. This is clear in the numbers. EY is the third largest firm by revenue and likely to remain that way for quite some time.

Strategy Goals/Evaluation Criteria

EY's goals should be as follows:

1. **Attract new clients and retain old ones**
   a. Evaluate: Number of clients (retention, attraction, revenues).
2. **Provide more value to clients**
   a. Evaluate: Client feedback (structured and unstructured), number of services provided, and the ROI of those services.
3. **Stay ahead of technology** (Provide the audit of the future)
   a. Evaluate: Benchmark services provided against other firms. Measure how much time it takes to complete an engagement and the output of that engagement. Increase the number of employees with technology-related titles. (New positions). Increase the training hours spent on emerging technology subjects.

Strategy Alternatives

Technology

1. **Use technology to strengthen EY's existing offerings** (Audit, Tax, Advisory).
   a. Increase the number of employees that are dedicated to improving EY's internal technologies. (Automation, client interaction, and analysis).
   b. Add dedicated employees to engagement teams to help them figure out how analytics and automation can help them.
   c. Improve the quality of the services provided by asking clients for feedback on how well EY understands their industry or anticipates their needs.
2. **Use technology to develop new services under the Advisory umbrella.**
   a. Hire more industry professionals or technology professionals (specialists) to further develop advisory offerings.
   b. Benchmark against competitors offerings.
   c. Ask clients what their biggest current issues with technology are and what they see upcoming in the next year, five years, ten years.

Increase Expertise

3. **Develop additional well-known areas of superior expertise.** This would be in the same vein as the Transaction Advisory and separate Financial Services groups described as potential competitive advantages above. Thes companies are selling expertise. This is proven when a company like Deloitte is known for its Consulting group

just because it is the oldest and the largest while PwC is known for its Tax practice for the same reasons.
    a. This may mean just reorganizing offices so that specific locations have strong bodies of expertise rather than spreading this knowledge geographically.
4. **Update employee training and development**. Public accounting firms put a lot of money and time into training their employees. There are just a few areas that EY should focus more time on to ensure that their employees are as effective as possible.
    a. Improve technology training. Employees need to be trained not only in technologies of today, but also in technologies of the future. There are a lot of tools like Tableau, R, and pivot tables that are not too difficult to put in the hands of the average auditor. More important is teaching the mindset that the auditor can ask and answer their own questions. Not every data question requires a data or computer scientist.
    b. Improve understanding of the business. While employees understand that they are working in a service industry and are serving a client, it's less often communicated that that means there is a huge client relationship/networking component to the business. Getting employees at every level of the company in on building relationships and maintaining connections could improve the way client acquisition and retention works.

Maintaining the Current Course

5. Finally, because of the stability of the industry and the awareness that these large, cutting-edge firms have of the changes they should be focusing on, **EY's current course may be the best one**. This would involve maintaining the strategic initiatives they are already pursuing including increased automation and focus on networking and building their brand.

Strategy Recommendations

I recommend that EY maintain its current course (5), but increase focus on technology (1 and 4) by backing it with measurable investment.

EY's Current Strategy:

- Focus on consistent branding
- Focus on cultural strengths: diversity, entrepreneurship
- Highlighting proficiencies: financial services, transaction advisory
- Developing technology initiatives: Robotic Process Automation, new client software

A Couple of Valuable Additions:

- Fund and staff emerging technology (dedicated teams and IT/Audit consultations)
- Fund and develop training. (Make sure the individual knows how they can personally start using technology and start being an active part of relationship management.)

Ultimately, most of these things are already being done. No firm is fuzzy on the value of technology in public accounting. Firms are beyond needing to be convinced about the importance of technology and have started begging colleges to incorporate these concepts into accounting curriculums so that they can hire more technologically aware accountants. They are developing these groups, hiring these people, and training these employees.

The issue is not what needs to be done, it’s how best to develop and communicate it to a global organization and an industry bound by slow-moving regulation.

Implementation Plan

Timeline

In the next Year:

- Put together a team to develop new training or update old training to focus more on these ideal distinctive competencies.
- Begin hiring more for IT roles. Design the mission statement of both designated groups and team “consultants.” Understand what kind of skills they need, what kind of training they need, and what the goals of these groups are.

In the next Five Years:

- Start developing and implementing proprietary audit/tax products that match the new technologies. (i.e. Can we automatically analyze data?)
- By now, accounting staff should understand the tools at their disposal and feel empowered to use them without help or calling it a whole new project/initiative.

In the next Ten Years:

- It it difficult to project this far given that technology is changing so rapidly. The vision of this plan, however, is that it won’t matter what the new technology is. Incorporating technology and empowering employees to use it will make EY a more agile firm, able to respond to change faster. This is difficult to accomplish bothe because of the highly regulated industry and because of how large the firm is. Communicating a mission and imbuing all employees with the same values can be difficult.

Contingency Plans

These firms have enough capital and enough non-negotiable demand that they are unlikely to fail because of this level of strategy shift. Additionally, failure of any of the Big Four would be very costly for the economy as their client base would need to be absorbed by the remaining firms and these switching costs are very high. This is why the Big Four are “too big to fail.”

The worst could still happen, however. If a firm was destroyed either by a social ethical issue or by some regulatory issue, EY would most likely need to spend some time absorbing both the employees and the clients of the folded firm. Fortunately, this would most likely be just a pause in these other pursuits and because of decreased competition may increase the fees that could be charged by the remaining firms.

Additional “worst case scenarios” are chiefly the fallout that is always a risk with technology. Employees or clients could resist change. This is an issue that every company deals with and could be addressed with additional training and consistently proving the value of the new methods or tools. There could be a data privacy issue or lawsuit which is particularly an issue as firms are more and more able to view *all* of a client’s data and as legislature lags further and further behind technology. This would be costly to reputation, financials, and potentially progress. None of these issues change the strategy that EY should pursue - just the velocity and recklessness at which is does so.

It is hard to imagine this strategy not working as it is relatively conservative but pivoting likely includes scaling back investment in dedicated technology employees or reevaluating what types of technology are really valuable.

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